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Transferability of credits – Final regulations
Tax Alert

Overview

Section 6418 provides that "eligible taxpayers" may elect to transfer (i.e., sell) certain credits to unrelated taxpayers rather than using the credits against their federal income tax liabilities. On April 30, 2024, Treasury and the IRS published in the Federal Register final regulations under section 6418 (T.D. 9993) (the "Final Regulations"). The Final Regulations finalize, with limited modifications, regulations proposed under section 6418 (REG-101610-23, the "Proposed Regulations") and removed the temporary regulations (T.D. 9975) setting forth mandatory information and registration requirements for transfer elections that were released on June 14, 2023.

The Final Regulations are effective on July 1, 2024. Specifically, the Final Regulations would apply to taxable years ending on or after April 30, 2024, and except for Treas. Reg. § 1.6418-4 (rules regarding pre-filing registrations and elections), taxpayers may choose to apply the Final Regulations to taxable years ending before April 30, 2024, provided the taxpayers apply the rules in their entirety and consistently.

Description of provisions

Consistent with the Proposed Regulations, the Final Regulations are divided into five sections:

- Treas. Reg. § 1.6418-1 generally provides that an eligible taxpayer may elect to transfer all or a portion of an eligible credit (determined with respect to any eligible credit property of such eligible taxpayer). The remainder of Treas. Reg. § 1.6418-1 provides definitions for terms used throughout the Final Regulations.
- Treas. Reg. § 1.6418-2 describes the general requirements for making a transfer election.
- Treas. Reg. § 1.6418-3 provides special rules with respect to transfer elections made by partnerships or S corporations.
- Treas. Reg. § 1.6418-4 establishes pre-filing registration requirements and describes other information required to make an effective transfer election.
- Treas. Reg. § 1.6418-5 provides special rules relating to excessive credit transfer penalties, basis reductions, required notifications, recapture

determinations with respect to transferred credits, and rules regarding carrybacks and carryforwards.

Who can sell credits?

A transfer election must be made by an "eligible taxpayer," which is a taxpayer that is not an "applicable entity" for purposes of making a direct pay election under section 6417. Generally, an eligible taxpayer will be any taxpayer that is not tax-exempt. Partnerships and S corporations may be eligible taxpayers, without regard to whether their partners or shareholders are themselves eligible taxpayers.

If an eligible taxpayer (including a partnership or S corporation) makes an election to claim direct payments under section 6417 for a section 45Q credit, section 45V credit, or section 45X credit (an "electing taxpayer"), the eligible taxpayer is deemed to be an applicable entity with respect to that credit and, as a result, is not considered an eligible taxpayer with respect to that credit during the period they have elected be treated as an applicable entity and receive direct payments.

Who can purchase credits?

As discussed above, eligible taxpayers can only transfer eligible credits to unrelated parties (within the meaning of section 267(b) or 707(b)(1)) in exchange for consideration "paid in cash." As described below, the Final Regulations detail the paid-in-cash requirement.

Which credits can be transferred?

Only "eligible credits" can be transferred. Eligible credits include the following:

Eligible Credits	
Section 30C alternative fuel vehicle refueling property credit	Section 45X advanced manufacturing production credit
Section 45 renewable electricity production tax credit	Section 45Y electricity production credit
Section 45Q carbon oxide sequestration credit	Section 45Z clean fuel production credit
Section 45U zero-emission nuclear power production credit	Section 48 energy investment tax credit
Section 45V clean hydrogen production credit	Section 48C qualifying advanced energy project credit
	Section 48E clean electricity investment credit

Each transfer election is made on a property-by-property or facility-by-facility basis except in the case of energy property described in section 48, where the eligible taxpayer may choose to make the transfer election with respect to an energy project. An eligible taxpayer may also elect to transfer specified portions of an eligible credit to multiple transferees, but the same credit cannot be sold to different parties or double-counted in any way.

With respect to section 45Q credits, the preamble to the Final Regulations indicates that the guidance under section 45Q does not require a taxpayer to own every component of a single process train for the capture, disposal, utilization, or injection of qualified carbon oxide to claim a section 45Q credit. Consistent with that guidance, the Final Regulations clarify that a transfer election for a section 45Q credit is determined with respect to a component of carbon capture equipment within a single process train, rather than the entire single process train. Any credit with respect to which a transfer election is made must have been determined with respect to the eligible taxpayer. With respect to this requirement, consistent with the Proposed Regulations, the Final Regulations provide that an eligible taxpayer who does

not directly determine the eligible credit by owning the underlying eligible credit property or conducting activities giving rise to the underlying eligible credit (e.g., a section 45Q credit or section 48 credit allowable to an eligible taxpayer because of an election made under section 45Q(f)(3)(B), or section 50(d)(5) and Treas. Reg. § 1.48-4, respectively) is ineligible for the transfer election with respect to that eligible credit. In addition, once transferred, credits cannot be transferred again (no second transfer rule). Market participants may not use dealers to facilitate transfers, as dealer arrangements generally violate the no second transfer rule. Market participants may, however, use brokers to facilitate transactions so long as the federal income tax ownership of the credit does not pass to the broker or any taxpayer other than the transferee taxpayer. The preamble to the Final Regulations also clarifies that, to the extent brokers provide liquidity, "any payments received by those taxpayers related to eligible credits will be taxable because the provisions of section 6418 will not prevent the inclusion of gross income for such taxpayers."

How to elect?

A transfer election is made on the eligible taxpayer's original return (including any revisions on a superseding return) for the taxable year in which the eligible credit is determined, but only after a registration number has been obtained pursuant to pre-filing registration requirements (discussed below). This return must be filed not later than the due date (including extensions). The transfer election cannot be made on the eligible taxpayer's amended return or by filing an administrative adjustment request under section 6227 ("AAR").

The Final Regulations provide limited relief by providing that a numerical error with respect to a properly claimed transfer election may be corrected on an amended return or by filing an AAR, if necessary, notwithstanding that a transfer election may not be made for the first time on an amended return, withdrawn on an amended return, or made or withdrawn by filing an AAR. The preamble to the Final Regulations provides that miscalculating the amount of the eligible credit on the original return or making a typographical error relating to a registration number are examples of numerical errors. The preamble explains that this would allow the eligible taxpayer to correct any errors that would result in a denial of the transfer election.

To the extent the eligible taxpayer's correction of an eligible credit in its amended return or AAR results in a change in the amount of the eligible credit reported, the Final Regulations require the amount to be reflected on the credit source forms with the eligible taxpayer's amended return or AAR. Specifically, with respect to any amount of increase in the eligible credit reported on the eligible taxpayer's amended return or AAR, such amount cannot be reflected by either the eligible taxpayer or the transferee taxpayer as a transferred specified credit portion on the transfer election statement. With respect to any amount of decrease on the eligible credit reported on the eligible taxpayer's amended return or AAR, such amount first reduces the amount of eligible credit retained by the eligible taxpayer (if any), and any excess reduces the specified credit portion reported by the transferee taxpayer. If the eligible credit was transferred to multiple transferee taxpayers, the reduction to each transferee taxpayer's specified credit portion is on a pro rata basis. In addition, the preamble clarifies that a reduction to the transferee taxpayer's specified credit portion may result in an excessive credit transfer (described below) with respect to the transferee taxpayer, and taxable income for the eligible taxpayer with respect to the payment received that directly relates to the excessive credit transfer.

The Final Regulations also provide an automatic six-month extension of time under Treas. Reg. § 301.9100-2(b) from the due date (excluding extensions) to provide relief for entities that file by the original due date of the return. Finally, the preamble clarifies that the transferee taxpayer may take or correct a

transferred specified credit portion into account in its properly filed amended return or AAR.

No separating bonus amounts from base credits

Consistent with the Proposed Regulations, the Final Regulations provide that an eligible taxpayer is not permitted to transfer "bonus amounts" related to an eligible credit separately from the "base" credit. Instead, if a portion of an eligible credit is transferred, the portion would include portions of both the "base" credit and any "bonus amount."

Anti-abuse rule

The Proposed Regulations provided an anti-abuse rule that would disallow a transfer of an eligible credit where the parties to the transaction have engaged in the transaction or a series of transactions with "the" principal purpose of avoiding tax liability beyond the intent of section 6418. The Final Regulations modify the Proposed Regulations by clarifying that the anti-abuse rule would apply to the extent parties have engaged in transactions with "a" principal purpose of avoiding tax liability beyond the intent of section 6418.

Consequences of election to transferor

Not included in gross income

The cash consideration received in exchange for the transfer of eligible credits is not included in the eligible taxpayer's gross income.

Rules for partnerships and S corporations

A transferor partnership or S corporation recognizes tax-exempt income with respect to cash received in exchange for a transferred credit, as of the date the credit is determined for the partnership or S corporation (such as, for investment credit property, the date the property is placed in service). There are no restrictions on how a partnership uses the proceeds of a credit sale, including how it makes distributions to its partners.

The tax-exempt income recognized by a transferor partnership with respect to a credit sale must generally be allocated among the partners based on the partners' distributive shares of otherwise eligible credits (i.e., the amount of credits that would have been allocated to each partner had a transfer election not been made). Consistent with the Proposed Regulations, the Final Regulations provide an exception to this general rule, which allows partnerships the flexibility to sell certain partners' shares of eligible credits and allocate the tax-exempt income from that sale to the "selling" partners, while also allocating any credit that is retained (i.e., not sold) to the "non-selling" partners. Otherwise stated, if a transferor partnership transfers less than all eligible credits with respect to an eligible credit property, the transferor partnership agreement may specially allocate the tax-exempt income and credits retained among partners, provided the eligible credits allocated to each partner do not exceed that partner's distributive share of eligible credits determined as if no transfer election was made. A partnership that is a partner of the transferor partnership (i.e., an upper-tier partnership) is not eligible for this special allocation rule. In addition, any tax-exempt income received by a transferor partnership or S corporation is not treated as passive income to any partners or shareholders and instead determined in connection with the conduct of an investment activity.

The amount of eligible credit determined with respect to investment credit property held directly by a transferor partnership or S corporation is determined by the transferor partnership or S corporation by taking into account the section 49 at-risk rules at the partner or shareholder level. Therefore, if the credit base of the investment credit property is limited to a

partner or shareholder by section 49, then the amount of the eligible credit determined by the transferor partnership or S corporation is also limited. However, changes to at-risk amounts under section 49 for partners or S corporation shareholders after the close of the taxable year in which the investment credit property is placed in service do not impact the eligible credit determined by the transferor partnership or S corporation. Additionally, the transferor partnership or S corporation is not required to provide notice to the transferee taxpayer of such changes.

If a partnership makes a transfer election with respect to an investment tax credit, a partner in the transferor partnership is subject to generally applicable recapture rules (sections 49(b) and 50(a)); however, importantly, the Final Regulations provide that for purposes of section 6418 only, a disposition of a partner's or S corporation shareholder's interest in a partnership or S corporation, which generally can cause recapture, will not be treated as a recapture event with respect to any transferred credits. Accordingly, if such dispositions occur, the transferor partnership or S corporation is under no obligation to inform the transferee taxpayer (because such disposition cannot affect the transferred credit). If a disposition of a partner's or shareholder's interest triggers a recapture event, the consequences of the recapture are imposed only upon the partner or S corporation shareholder (and not upon the transferee taxpayer). In addition, the recapture amount recognized by the partner or shareholder of the transferor partnership or S corporation reduces the remaining credit amount subject to recapture with respect to the transferee taxpayer and eligible taxpayer (to the extent of the retained credit amounts that have not been previously recaptured). The Final Regulations provide an example illustrating the impact of partner or shareholder recapture on the remaining recapture amount.

Consequences of election to transferee

When transferred credit is available

Transferee taxpayers account for the credits they purchase in the first taxable year ending with or after the taxable year of the eligible taxpayer with respect to which the transferred credit is determined. For example, if a transferee taxpayer with a June 30 taxable year-end purchases credits determined in 2024 from a calendar-year eligible taxpayer, the transferee taxpayer will account for the purchased credits on its federal tax return ending June 30, 2025. A transferee taxpayer may account for credits it has purchased or intends to purchase when calculating its estimated tax payments. A transferee taxpayer may also carry back purchased credits for up to three years.

Paid-in-cash requirement

Amounts transferred to the eligible taxpayer in consideration for eligible credits must be "paid in cash" during a window of time related to when the credit is determined with respect to the eligible taxpayer. The Final Regulations provide that "paid in cash" means payment in United States dollars and contemplate payments by cash or similar methods of transferring immediately available funds. Payments must be made no earlier than the first day of the eligible taxpayer's taxable year during which the credit is determined and no later than the due date for completing a transfer election statement (as detailed within the section 6418 regulations). A contractual commitment to purchase eligible credits in advance is allowed, so long as the cash payments are made during the relevant time period. Similarly, there is no prohibition on either a transferee taxpayer or another third-party loaning funds to an eligible taxpayer (including loans secured by an eligible credit purchase and sale agreement), provided such loans are at arm's length and treated as loans for federal income tax purposes. The preamble clarifies that "[w]hether the loans are treated as upfront payments for eligible credits or otherwise

recharacterized is an analysis based on the facts and circumstances of the loan."

Additionally, the Final Regulations make clear that transferee taxpayers do not recognize gross income attributable to the difference between the amount transferee taxpayers pay for credits and the amount of credits transferred to and claimed by the transferee taxpayer.

Treasury and the IRS do not address the treatment of transaction costs in connection with the transfer election in the Final Regulations; however, Treasury and the IRS anticipate issuing further guidance taking into account the comments received regarding transaction costs.

Transferred credits subject to passive activity rules

The Proposed Regulations provided that a transferee taxpayer subject to section 469 would be required to treat the eligible credits as passive activity credits (as defined in section 469(d)(2)) to the extent the portion exceeds the regular tax liability of the taxpayer allocable to passive activities. While the preamble to the Final Regulations considered comments regarding whether the passive activity rules should apply to those who purchase credits, the Final Regulations continue to limit the ability of transferee taxpayers, subject to section 469 (such as individuals), to be able to use transferred credits. Accordingly, the Final Regulations generally adopt the proposed rule with respect to section 469, but provide a limited exception for a transferee taxpayer who materially participates in an eligible credit generating activity within the meaning of section 469(h) in which the transferee taxpayer owns an interest at the time the work was done (assuming the transferee taxpayer is not related to the eligible taxpayer). Last, no grouping would be allowed to recharacterize the taxpayer's participation.

Transferred credits not eligible for direct pay

Final regulations released in March under section 6417 do not permit direct pay elections by a transferee taxpayer for any transferred credit ("chaining"). However, the IRS and Treasury have issued a notice (Notice 2024-27) requesting comments for whether chaining should be permitted.

Recapture

Certain eligible credits (e.g., the energy credit under section 48, qualifying advanced energy project credit under section 48C, the clean electricity investment credit under section 48E (collectively, "the investment credit"), and the credit for carbon oxide sequestration under section 45Q(a)) are subject to potential recapture. Under the Final Regulations, a recapture event triggers reciprocal notice requirements as between the eligible taxpayer and the transferee taxpayer. The eligible taxpayer must notify the transferee taxpayer of the recapture event and provide the information necessary for the transferee taxpayer to calculate the recapture amount. The transferee taxpayer must then provide notice to the eligible taxpayer of the recapture amount in order for the eligible taxpayer to calculate any basis adjustments determined with respect to the investment credit property as relating to the recapture amount.

Allocation of recapture between the eligible taxpayer and the transferee taxpayer(s)

The Final Regulations provide rules with respect to the allocation of the recapture amount between the eligible taxpayer and the transferee taxpayer(s). If the eligible taxpayer retains an amount of eligible credit subject to recapture (i.e., does not transfer all eligible credits to the transferee taxpayer(s)), the Final Regulations provide that the recapture amount is shared by the eligible taxpayer and the transferee taxpayer(s) in proportion to each

taxpayer's retained credit (in the case of the eligible taxpayer) or specified credit portion (in the case of the transferee taxpayer). The Final Regulations provide examples illustrating the allocation of recapture amount among the eligible taxpayer and multiple transferee taxpayers.

Effect of recapture on the transferee taxpayer

If a recapture event occurs, the transferee taxpayer loses all or a portion of the benefit of the transferred credit and must adjust its federal tax liability upwards to reflect the recaptured portion of the transferred credit.

The Final Regulations do not address the contractual remedies, insurance arrangements, or other ways in which transferee taxpayers are expected to protect themselves against the risk posed by potential recapture; however, the Final Regulations do provide that the reciprocal recapture notice requirements can be elaborated by contract, provided that the contractual arrangement does not conflict with the notice requirements set out in the Final Regulations.

Effect of recapture on the transferor eligible taxpayer

After informing the transferee taxpayer of the recapture event and receiving notice of the recapture amount, the eligible taxpayer increases the adjusted tax basis of any investment credit property (including the recapture amount provided by the transferee taxpayer and the recapture amount on any credits retained by the eligible taxpayer), in accordance with section 50.

Pre-filing registration required

An effective transfer election requires obtaining a registration number, on a property-by-property, facility-by-facility, or energy project basis, prior to completing the transfer election statement, which enables a transferee taxpayer to claim the benefit of the transferred credit. The preamble to the Final Regulations clarifies that if any underlying Code section allows grouping to determine a qualified property, then grouping for purposes of obtaining a registration number for that qualified property is permitted. Registration numbers can only be obtained through an electronic portal maintained by the Service. Registration is required on a per-member basis for members of consolidated groups. Registration generally requires providing certain information about the electing taxpayer and relevant eligible property, including name, TIN or EIN, type of entity, taxable year, the credit(s) being elected, and location and type of credit property. Registration numbers are valid only for one taxable year. A transferee taxpayer is also required to report the registration number received from an eligible taxpayer on its return for the taxable year that the transferee taxpayer takes the transferred eligible credit into account.

Excessive credit transfer penalties

Credit transfers under section 6418 are potentially subject to a 20% penalty on the amount of an "excessive credit transfer." Specifically, excessive credit transfers are defined as the excess of the transferred credit claimed by the transferee taxpayer over the amount of the eligible credit that would otherwise be allowable under the Code. In the event of an excessive credit transfer, the transferee taxpayer not only loses the financial benefit of the excessive credit transfer amount, but also must pay a penalty equal to 20% of the excessive credit transfer amount unless the transferee taxpayer can show the excessive credit transfer resulted from reasonable cause. The Final Regulations provide that credit recapture is not treated as an excessive credit transfer. The Final Regulations also list non-exhaustive factors for determining the existence of reasonable cause.

Circumstances that may indicate reasonable cause include: (1) review of the eligible taxpayer's records with respect to the determination of the eligible

credit (including documentation evidencing eligibility for bonus credit amounts), (2) reasonable reliance on third party expert reports, (3) reasonable reliance on representations from the eligible taxpayer that the total specified credit portion transferred does not exceed the total eligible credit determined with respect to the eligible credit property for the taxable year, and (4) review of audited financial statements provided to the Securities and Exchange Commission, if applicable.

Lastly, the Final Regulations treat multiple transferees as one for purposes of calculating whether there was an excessive credit transfer and the amount of any such excessive credit transfer penalty. Each transferee taxpayer shares proportionally with respect to the risk that the IRS may impose a penalty based on a redetermination of the eligible credit amount, but only to the extent of each transferee taxpayer's share of the transferred credit.

Special rules for real estate investment trusts (REITs)

The Final Regulations provide that eligible credits that have not yet been transferred after being generated in the hands of a REIT are disregarded (i.e., not included in the numerator or denominator) for purposes of determining the value of the REIT's total assets in section 856(c)(4). Further, the preamble to the Final Regulations clarifies that a REIT would not be treated as receiving gross income upon becoming entitled to a credit against federal income tax under general federal income tax rules, as those rules do not trigger the recognition of gross income upon becoming entitled to a federal income tax credit.

The Final Regulations also provide that a sale of an eligible credit pursuant to a valid transfer election under section 6418 is not considered a sale for purposes of the requirement that limits the number of sales a REIT may have under the prohibited transaction safe harbor in section 857(b)(6)(C)(iii) and (D)(iv).

Lastly, the preamble to the Final Regulations reiterates the IRS's position in the preamble to the 2016 final regulations (T.D. 9784, providing rules on the definition of real property) that, until additional guidance is published, the IRS will not treat any net income from the sale of electricity to a utility company as a prohibited transaction under section 857(b)(6) so long as the quantity of excess electricity transferred to the utility company does not exceed the quantity of electricity purchased from the utility company. Any sale of electricity that is not within this scope would be analyzed on a facts and circumstances basis to determine whether the sale is a prohibited transaction.

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